

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Standard Manufacturing Co., Inc. : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation :
Franchise Tax under Article 9A of the Tax Law for :
the Years Ended 7/31/78 & 7/31/79. :

State of New York }

ss.:

County of Albany }

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 2nd day of May, 1984, he served the within notice of Decision by certified mail upon Standard Manufacturing Co., Inc., the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Standard Manufacturing Co., Inc.
750 Second Ave.
Troy, NY 12182

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
2nd day of May, 1984.

David Parchuck

James J. O'Donnell
Authorized to administer oaths
pursuant to Tax Law section 174

STATE TAX COMMISSION

for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation
Franchise Tax under Article 9A of the Tax Law for :
the Years Ended 7/31/78 & 7/31/79.

Bonnie A. Hagebund
Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

May 2, 1984

Standard Manufacturing Co., Inc.
750 Second Ave.
Troy, NY 12182

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
Gary L. Lombardi
Lombardi, Reinhard, Walsh & Harrison, P.C.
P.O. Box 1053, 433 State St.
Schenectady, NY 12301
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
STANDARD MANUFACTURING CO., INC.	:	DECISION
for Redetermination of a Deficiency or for	:	
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Fiscal Years	:	
Ended July 31, 1978 and July 31, 1979.	:	

Petitioner, Standard Manufacturing Co., Inc., 750 Second Avenue, Troy, New York 12182, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended July 31, 1978 and July 31, 1979 (File No. 32654).

A formal hearing was held before Dennis M. Galliher, Hearing Officer, at the offices of the State Tax Commission, Building #9, State Office Campus, Albany, New York, on November 9, 1982 at 9:15 A.M., with all briefs to be submitted by March 3, 1983. Petitioner appeared by Lombardi, Reinhard, Walsh & Harrison, P.C. (Gary L. Lombardi, Esq. and Richard P. Walsh, Esq., of counsel). The Audit Division appeared by Paul B. Coburn, Esq. (Harry Kadish, Esq., of counsel).

ISSUE

Whether the Audit Division may properly require petitioner, Standard Manufacturing Co., Inc., and its subsidiary Caribbean Outerwear Corporation to file combined franchise tax reports for the fiscal years ended July 31, 1978 and July 31, 1979.

FINDINGS OF FACT

1. On December 10, 1980, the Audit Division issued to petitioner, Standard Manufacturing Co., Inc., separate notices of deficiency pertaining to each of the (petitioner's) fiscal years ended July 31, 1978 and July 31, 1979. These notices of deficiency asserted additional tax due of \$92,810.33 for the fiscal year ended August 31, 1978, and \$58,590.57 for the fiscal year ended August 31, 1979, plus interest for each year.

2. Separate statements of audit adjustment dated October 30, 1980, and pertaining to each of the above fiscal years, contained computations in explanation of the dollar amounts of additional tax asserted as due, as well as an explanation that the "...estimated deficiency is for failure to file a New York State franchise tax report, Form CT-3, for Caribbean Outerwear Corp. and to include such income on the combined report of Standard Manufacturing Co...".

3. Standard Manufacturing Co., Inc. ("Standard") was incorporated under the laws of New York State in December, 1960 and is engaged in the business of manufacturing highly-styled (fashionable) garments, worn for warmth and known as "outerwear". The board of directors of Standard is comprised of three individuals, George Arakelian, John Arakelian and Dorothy King, who also serve as president, vice-president and secretary-treasurer, respectively, of Standard. In addition, these three individuals own, in approximately equal shares, all of the outstanding stock of Standard.

4. Caribbean Outerwear Corporation ("Caribbean") is a wholly-owned subsidiary of Standard, incorporated in 1968 under the laws of the State of Delaware. Caribbean's principal place of business is located in Jebuyoa, Puerto Rico. Caribbean is engaged in the manufacture of highly-styled outerwear, and also of "activewear", including garments such as tennis clothing and other

sports outfits designed to be both fashionable as well as functional. The garments made by Caribbean differ from those made by Standard in that Caribbean's garments are more highly-styled. In addition, Standard makes no activewear.

5. Standard owns one hundred percent of the outstanding stock of Caribbean, and George Arakelian, John Arakelian and Dorothy King serve as Caribbean's board of directors and as its officers.

6. Caribbean's facilities are located in Puerto Rico because of the availability there of the skilled labor force needed to manufacture the garments sold by Caribbean. At the time Caribbean was being set up to operate, Sixto Gonzalez was hired to be Caribbean's "chief operating officer" in Puerto Rico. Mr. Gonzalez did not become a member of Caribbean's board of directors, nor did he replace the previously-noted officers of Caribbean (see Finding of Fact "5").

7. Mr. Gonzalez earned a Bachelor of Science degree in Industrial Engineering from the University of Puerto Rico, School of Engineering. He also earned an Associate's Degree from the Fashion Institute of Technology in New York City, with course work emphasizing pattern making and design, and fabric analysis and grading, as well as the more traditional business/financial courses dealing predominantly with the particulars of the fashion industry. After completing his education, Mr. Gonzalez worked in various managerial capacities for several fashion and garment manufacturing concerns. Mr. Gonzalez was chosen by George Arakelian and hired by Caribbean because, in view of his education and experience, he was felt to be completely qualified to manage all aspects of Caribbean's operation.

8. Upon being hired by Caribbean, Mr. Gonzalez commenced making arrangements for the modifications necessary to transform a building purchased previously by Caribbean into a functional, operating, manufacturing facility. His actions in

this regard included contracting for certain modifications to the layout of the building, for electrical installations, and for equipment purchases. Mr. Gonzalez also was responsible for setting up Caribbean's production lines, determining the number of clerical and production personnel necessary, hiring such personnel, setting hours worked, wages to be paid,¹ vacation and holiday schedules, etc., and for handling relations between Caribbean and the Puerto Rican government. Finally, Mr. Gonzalez was responsible for establishing production levels and determining production costs, and was involved in the immediate and long-range planning and development of new merchandise, markets and customers for Caribbean. Several "department heads", including a plant manager, a cutting room manager and warehouse managers reported directly to Mr. Gonzalez.

9. Mr. Gonzalez approved invoices and authorized payment of bills by Caribbean. He also handled negotiations (often in conjunction with Caribbean's legal counsel) with Puerto Rican officials concerning environmental matters, OSHA and plant expansion. The most expensive machinery used by Caribbean costs approximately ten to fifteen thousand dollars, and could be purchased by Mr. Gonzalez, if necessary, without first obtaining approval from Caribbean's Board of Directors. Mr. Gonzalez also purchased the raw materials used by Caribbean in manufacturing the garments.

10. Mr. Gonzalez was required to report annually to Caribbean's board of directors concerning the status of Caribbean's operations and the projection of costs for future products, orders and operations (manufacturing). Projects requiring large capital outlays, such as plant expansion (which has occurred

¹ Some of Caribbean's employees are salaried while others are paid on a piecework (units of production) basis.

during Caribbean's lifetime) would be discussed at this annual meeting and would require the approval of Caribbean's board of directors.

11. Caribbean maintained and paid the expenses of its own sales office, showroom, sales personnel and designers located in Jebuyoa, Puerto Rico.

12. Standard did not train Caribbean's personnel, nor did it exchange personnel with or offer technical advice to Caribbean. There was no centralized warehousing of goods or raw materials nor any internal (intercompany) transfer of (raw) materials. Each company had its own separate accountants and legal counsel.

13. Garments purchased by Standard from Caribbean were completed goods to which Standard did not add any finishing steps. Standard had other subsidiaries which manufactured goods different from those made by Caribbean. No business was conducted between Caribbean and Standard's other subsidiaries.

14. There were no intercorporate loans or other financing arrangements, as such, between Standard and Caribbean, and Caribbean had its own one million dollar line of credit with the Banco Popular de Puerto Rico.

15. Caribbean operated its manufacturing facilities only in Puerto Rico, and had no place of business, mailing address, telephone listing, bank accounts, inventory or supplies in New York State. Caribbean had no collection procedures in New York. Goods manufactured by Caribbean were shipped F.O.B. factory and title to the goods was passed to the buyer at the factory in Puerto Rico.

16. Caribbean's garments were manufactured based on either its own "prototype" designs which customers had ordered, or on samples sent by customers and modified by Caribbean to fit its machines and production capabilities. Materials needed for manufacturing were purchased by Mr. Gonzalez in Puerto Rico and in the United States. Before a garment was manufactured in quantity, its price

was determined by Mr. Gonzalez based on all direct and indirect costs involved in the manufacture of the garment, plus a markup amount for profit. This price was then subject to the customer's approval before an order was filled. No information was presented with regard to the markup amount or percentage for profit charged by Caribbean.

17. Caribbean maintained its bank account with the Banco Popular de Puerto Rico in Puerto Rico. All checks issued by Caribbean bore the signature of Dorothy King. Her signature was affixed by means of a check-signing machine, to which Mr. Gonzalez had access and through which he authorized and effected payment of Caribbean's bills. According to testimony, this check-signing procedure was employed in order to comply with a requirement under Puerto Rican law that only members of the corporation's board of directors could sign corporate checks in Puerto Rico.

18. George Arakelian testified that Caribbean was organized with the aim of generating a profit on its sales, and was not required to sell exclusively to Standard (or to any other entity). During the initial years of its operation, one hundred percent of Caribbean's sales were made to Standard. During these initial years, Caribbean manufactured its garments according to the design specifications and in the quantities needed by Standard.

19. During the fiscal years at issue, approximately ninety percent of Caribbean's sales were made to Standard, while the remaining ten percent of its sales were made to various other customers. This change from selling exclusively to Standard occurred over a period of years during which time Caribbean and its products became known, and during which time Caribbean's manufacturing facilities were expanded (see Finding of Fact "10").

20. Caribbean is listed in The Industrial and Commercial Catalogue of Puerto Rico and in the Membership Directory; Puerto Rican Manufacturer's Association. Mr. Gonzalez testified that these catalogues are the official directories listing all Puerto Rican manufacturers and suppliers, and their products and services, and that being listed in these catalogues is the "normal" manner by which companies (especially those in the garment manufacturing industry) in Puerto Rico "advertise" and make known their products and services. Caribbean did not otherwise advertise by publication, and has assertedly attracted some customers other than Standard through "word-of-mouth" advertising.²

21. Standard did not determine or dictate the other customers to whom Caribbean sold, nor did Standard dictate the types of products made and sold by Caribbean to these customers. Standard asserts that all sales between it and Caribbean were made as "arm's length" transactions, and that at times Standard has refused to have certain goods manufactured by Caribbean because the cost of the goods, as projected by Mr. Gonzalez, was too high.

22. Standard asserts that an "agreement" between Standard, Caribbean and the Internal Revenue Service assures that transactions between Standard and Caribbean, with respect to the sale of goods, result in arm's length prices for the goods. However, this "agreement" consisted of a statement of (Internal Revenue Service) Income Tax Examination Changes wherein, inter alia, the price of goods from Caribbean to Standard during the fiscal years ended August 31, 1973, August 31, 1976 and August 31, 1977 were adjusted under Internal Revenue Code section 482 to reflect an arm's length price. No similar document or

² Mr. Gonzalez is listed under the title of "manager" in both of the catalogues introduced as evidence.

evidence of any agreement pertaining to the fiscal years at issue was offered by Standard.

23. Only approximately one to two percent of Caribbean's profits per year have been received by Standard, with all other profits remaining undistributed in Puerto Rico. This practice is maintained so that Caribbean may comply with the requirements and receive the benefits of Internal Revenue Code section 936 (Puerto Rico and Possession Tax Credit).

24. Standard and Caribbean did not file consolidated federal tax returns or consolidated financial statements during the fiscal years at issue.

25. The Audit Division and Standard have agreed, in the event the Commission finds Standard is required to file a combined franchise tax report including Caribbean, that the tax due shall be determined by a business allocation percentage (Tax Law §210.3), and that for the fiscal years at issue, the deficiencies shall be revised as follows:

<u>FISCAL YEAR ENDED</u>	<u>DEFICIENCY</u>
July 31, 1978	\$11,599.63
July 31, 1979	16,003.22
Total	<u>\$27,602.85</u>

CONCLUSIONS OF LAW

A. That subdivision 4 of section 211 of the Tax Law provides, in relevant part, as follows:

"In the discretion of the tax commission, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more corporations..., may be required or permitted to make a report on a combined basis covering any such other corporation...; provided, however, that no combined report covering any corporation not a taxpayer shall be required unless the tax commission deems such a report necessary, because of inter-company transactions, or some agreement, understanding, arrangement or transaction referred to in subdivision five of this section, in order properly to reflect the tax liability under this article...".

B. That regulations of the State Tax Commission in pertinent part provide:

"(a) ... In deciding whether to permit or require combined reports the following two broad factors must be met:

- (1) the corporations are in substance parts of a unitary business conducted by the entire group of corporations, and
- (2) there are substantial intercorporate transactions among the corporations.

(b) In deciding whether each corporation is part of a unitary business, the Tax Commission will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:

- (1) manufacturing or acquiring goods or property for other corporations in the group; or
- (2) selling goods acquired from other corporations in the group; or
- (3) financing sales of other corporations of the group.

The Tax Commission will consider a corporation to be part of a unitary business if it is engaged in the same or related lines of business as the other corporations in the group, such as:

- (4) manufacturing similar products; or
- (5) performing similar services; or
- (6) performing services for the same customers.

(c) In determining whether the substantial intercorporate transaction requirement is met, the Tax Commission will consider only transactions directly connected with the business conducted by the taxpayer, such as described in paragraph (1), (2), or (3) of subdivision (b) of this section. Service functions such as accounting, legal, and personnel will not be considered. The substantial intercorporate transaction requirement may be met where as little as 50 percent of a corporation's receipts are from any qualified activities." (20 NYCRR 6-2.3)

C. That since Caribbean is a wholly-owned subsidiary of Standard, the stock ownership or control requirement of the statute (§211.4) is clearly met. Thus, a determination concerning whether or not combined filing is required rests upon a finding that Standard and Caribbean are in substance parts of a

unitary business and that there are substantial intercorporate transactions between the two. Moreover, it must be determined whether "under all of the circumstances of the intercompany relationship, combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income [citation omitted]." Matter of Coleco Industries, Inc. v. State Tax Comm., 92 A.D.2d 1008, 1009, aff'd mem., 59 N.Y.2d 994.

D. That it is clear from the facts presented that there were substantial intercorporate transactions between petitioner and Caribbean, and that the two corporations were parts of the same unitary business. Both Standard and Caribbean were engaged in manufacturing and selling similar products, specifically clothing. While Standard manufactured no "activewear", both corporations manufactured "outerwear" differing only as to the degree of styling incorporated into the garments. During the years at issue, ninety percent (90%) of Caribbean's goods were manufactured for and sold to Standard, with Standard thereafter adding no further labor or styling to these goods before selling them. Notwithstanding the title and overall function of Mr. Gonzalez, ultimate control over Caribbean, and over Standard as the purchaser of ninety percent of Caribbean's output, rested with the three common officers and directors of Caribbean and Standard. Finally, while an amount or percentage was not specified, it is clear that the major portion of Caribbean's income (and hence its undistributed profits) was generated by its transactions with Standard.

E. That no details were given concerning the markup amount or profit percentage charged by Caribbean on its sales to Standard or to any of its other customers. The transactions between Standard and Caribbean were alleged to have been "arm's length" sales. However, the document introduced by Standard in support of this proposition (see Finding of Fact "22") pertains to years

prior to those at issue, and reveals only that upon audit the Internal Revenue Service adjusted the pricing of goods sold by Caribbean to Standard (in those prior years) to arrive at arm's length prices. There is thus no certainty that during the years at issue the prices paid were based upon arm's length bargaining or market factors. To the contrary, repeated Federal audit changes militate against the petitioner rather than support its claim of arm's length transactions, because those federal changes evidence a pattern of unrealistic pricing corrected only after audit. In view of the general corporate structure, the presence of distortion may thus be inferred as to any income or losses not specifically reviewed by Federal auditors. Accordingly, it was proper to require petitioner to include its subsidiary Caribbean on a combined franchise tax report.

F. That the petition of Standard Manufacturing Co., Inc. is hereby denied and the notices of deficiency dated December 10, 1980, as revised in accordance with Finding of Fact "25", together with such interest as may be lawfully owing, are sustained.

DATED: Albany, New York

STATE TAX COMMISSION

MAY 02 1984

Rodriguez Wilson
PRESIDENT

Francis R. Koenig
COMMISSIONER

Mark J. Jirulak
COMMISSIONER